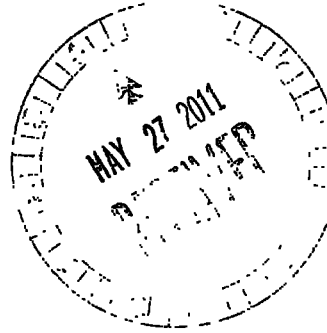


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MAYER • BROWN



Mayer Brown LLP
1999 K Street, N.W.
Washington, D.C. 20006-1101

Main Tel +1 202 263 3000
Main Fax +1 202 263 3300
www.mayerbrown.com

Robert M. Jenkins III
Direct Tel +1 202 263 3261
Direct Fax +1 202 263 5261
rmjenkins@mayerbrown.com

May 27, 2011

BY HAND-DELIVERY

Cynthia Brown
Chief, Section of Administration
Office of Proceedings
Surface Transportation Board
395 E Street, SW
Washington, DC 20423

Re: Competition in the Railroad Industry
Ex Parte 705

ENTERED
Office of Proceedings

MAY 27 2011

Part of
Public Record

Dear Ms. Brown:

Enclosed for filing the in the above-referenced proceeding are an original and ten copies of the "Reply Comments of BNSF Railway Company." Please date-stamp the enclosed extra copy and return it to our representative. Thank you.

Sincerely yours,

A handwritten signature in black ink, appearing to read "RMJ", followed by the printed name "Robert M. Jenkins III".

Robert M. Jenkins III

RMJ/bs

Enclosure

229639

CONTAINS COLOR IMAGES

**BEFORE THE
SURFACE TRANSPORTATION BOARD**



EX PARTE NO. 705

COMPETITION IN THE RAILROAD INDUSTRY

**REPLY COMMENTS OF
BNSF RAILWAY COMPANY**

**ENTERED
Office of Proceedings**

MAY 27 2011

**Part of
Public Record**

Roger P. Nober
Richard E. Weicher
Jill K. Mulligan
BNSF RAILWAY COMPANY
2500 Lou Menk Drive
Fort Worth, TX 76131

Robert M. Jenkins III
MAYER BROWN LLP
1999 K Street, NW
Washington, DC 20006

Counsel for BNSF Railway Company

Dated: May 27, 2011

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

**EX PARTE NO. 705
COMPETITION IN THE RAILROAD INDUSTRY**

**REPLY COMMENTS OF
BNSF RAILWAY COMPANY**



MAY 27 2011

Part of
Public Record

BNSF Railway Company submits these reply comments pursuant to the Board's decisions served January 11 and February 4, 2011, in this proceeding. Attached in support of these comments is the verified statement of John P. Lanigan, Executive Vice President and Chief Marketing Officer for BNSF.

INTRODUCTION

Since the Staggers Rail Act of 1980, Pub. L. No. 96-448, 94 Stat. 1895 ("Staggers Act"), the railroad industry has made significant investment in infrastructure and equipment to the immense benefit of its customers and the nation at large. As implemented by the Interstate Commerce Commission ("ICC"), the market-based regulatory model mandated in the Staggers Act was so successful that Congress reinforced that mandate when it passed the mantle to the Surface Transportation Board ("STB") in the ICC Termination Act of 1995, Pub. L. No. 104-88, 109 Stat. 803 ("ICCTA"). In the post-Staggers era, the STB has adopted regulatory policies aimed at preserving a careful balance between reliance on market forces to establish reasonable rates and protecting shippers from abuse of market power.

Under the current regulatory regime, competitive access remedies are reserved for demonstrated abuses of market power. Commenting parties seeking more intrusive regulation

bear a heavy burden of showing why changes to the existing regime, which already provides ample recourse for shippers claiming abuse of market power through its existing rate reasonableness and competitive access mechanisms, are necessary and represent good public policy.

The commenters in this proceeding arguing for more access regulation have not met that heavy burden. Most of their arguments simply reprise claims that have been made to the ICC, the STB, and the courts for over two decades. Somewhat distinctively here, many of the commenters rely on unsupported claims of “duopoly power” arising from rail mergers, “parallel pricing,” and railroads awash in excess profits.¹ These claims, however, are equally unavailing. The rail mergers of the 1990s made the industry *more* competitive, not less. The efficiency and productivity of the industry produced both lower prices and better service. As Mr. Lanigan explains in his verified statement, BNSF competes daily with other railroads, trucking companies, and barge companies by providing competitive, high-value service. The real focus of most of the shipper commenters appears to be the *level* of the rates they are charged for this service—as they have been for most of the three decades since the passage of the Staggers Act. They point to recent rate increases and urge the Board to adopt changes under the rubric of access as a means of obtaining lower rail rates than what the Board’s existing rate regulation would prescribe. In fact, as described herein, after falling steadily for over two decades, rail prices began to increase in the mid-2000s because demand and costs increased, not because of a

¹ See, e.g., Comments of Concerned Captive Coal Shippers (“CCCS Comments”); Comments of The Fertilizer Institute (“TFI Comments”); Comments Submitted by Olin Corporation (“Olin Comments”); Comments of Omaha Public Power District, Et Al. (“OPPD Comments”); Comments of Western Coal Traffic League (“WCTL Comments”); Initial Comments of Arkansas Electric Cooperative Corporation (“AECC Comments”); Initial Comments of Westlake Chemical Corporation (“Westlake Comments”); Joint Comments of Alliance for Rail Competition, Et Al. (“Alliance Comments”).

lack of competition between railroads. Rail prices are still far below their levels in 1980 in real terms, and the shipping public has benefited enormously from the reinvestment made possible by the industry's improved financial condition.

Further, the fact that railroads have become more profitable and better able to attract investment capital today does *not* mean that they have achieved the kind of sustained profitability that will enable them to replace their assets in the long run. Depriving railroads of revenues simply because they have more revenues and are closer to a self-sustaining financial *future* is the surest way of preventing that future from being reached.

In sum, calls for reopening mergers and imposing new regulatory requirements that would siphon revenues from efficient operations are misguided and contrary to the interests of the majority of BNSF's shippers. There is ample regulation in place to protect shippers against unreasonable rates, poor service, or other abuses. Comments filed in this proceeding have not shown why the STB should abandon its current, more balanced regulatory regime and adopt an uncertain radical new approach to access regulation.

I. THE ROLE OF ECONOMIC REGULATION OF RAILROADS

As the Board is well aware, the nation learned the hard way in the 1960s and 1970s that railroads operate in largely competitive markets and that regulation that attempted to mandate non-market-based pricing or operations would, over time, bankrupt the industry. A significant number of major railroads in the Northeast and Midwest in fact went bankrupt, and most others were in poor financial condition. *See* S. Rep. No. 609, 93rd Cong., 1st Sess. 5-13 (1973).

Congress found that the crisis had been caused in substantial part by a pervasive, inflexible regulatory scheme administered by the ICC, which promoted equalized rates and "open routing" and hindered the efforts of individual railroads to achieve greater efficiency and compete

successfully with other transportation modes. *See, e.g.*, S. Rep. No. 499, 94th Cong., 1st Sess. 10-11 (1975) (“[T]he present regulatory system has sapped the ability of railroads to respond, compete, innovate, and develop their full service capacity.”); H.R. Rep. No. 1430, 96th Cong., 2nd Sess. 111 (1980). *See generally* T. Keeler, *Railroads, Freight and Public Policy*, 24-32 (1980).

Congress made the first effort to free up the regulatory stranglehold on the industry in the Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, 90 Stat. 31 (“4R Act”), but the ICC was slow to react to the imperative for reduced regulation. Frustrated with the ICC’s lack of progress and the continuing financial crisis in the rail industry, Congress four years later enacted the Staggers Act, which mandated much more extensive deregulation of the industry. This time the ICC responded appropriately to Congress’s mandate. The ICC in the ensuing years adopted and implemented rules and exemptions that generally adhered to the principle that the markets for rail service would be allowed to operate freely, and regulation would be applied only in situations where it was proven necessary to protect a shipper against a demonstrated abuse of market power.²

² *See, e.g.*, *Western Railroads Agreement*, 364 I.C.C. 635 (1981) (rejecting prior regime of “equalized rates” and “open routing”); *Rulemaking Concerning Traffic Protective Conditions in Railroad Consolidation Proceedings*, 366 I.C.C. 112 (1982) (same), *rev’d on other grounds sub nom. Detroit, Toledo & Ironton Ry. v. ICC*, 725 F.2d 47 (1984); *Standards for Intramodal Rail Competition*, STB Ex Parte No. 445 (served July 7, 1983) (encouraging independent rate and route actions, and reserving regulatory intervention for anticompetitive conduct); *Coal Rate Guidelines—Nationwide*, 1 I.C.C.2d 520 (1985) (adopting rate reasonableness standards recognizing the necessity for market-based, differential pricing), *aff’d sub nom. Consolidated Rail Corp. v. United States*, 812 F.2d 1444 (3d Cir. 1987); *Exemption from Regulation—Boxcar Traffic*, 367 I.C.C. 424 (1983) (exempting traffic from regulation where abuse of market power unlikely), *aff’d in relevant part sub nom. Brae Corp v. ICC*, 740 F.2d 1023 (D.C. Cir. 1984); *Intramodal Rail Competition*, 1 I.C.C.2d 822 (1985) (adopting rules for addressing allegations of anticompetitive conduct in individual cases) (served Oct. 31, 1985), *aff’d sub nom. Baltimore Gas & Electric v. United States*, 817 F.2d 108 (D.C. Cir. 1987); *Midtec Paper Corp. v. Chicago & North Western Transp. Co.*, 3 I.C.C.2d 171 (1986) (restricting application of competitive access rules to situations where anticompetitive abuse occurs), *aff’d sub nom. Midtec Paper Corp. v. United States*, 857 F.2d 1487 (D.C. Cir. 1988).

So successful was that approach that when Congress passed ICCTA in 1995, it reduced regulation still further, and reinforced the mandate that, “to the maximum extent permissible by law,” regulation should be applied only to protect against market abuse. *See* 49 U.S.C. § 10502(a); H.R. Rep. No. 104-311, 104th Cong., 1st Sess. 91 (1995), at 96. Consistent with that statutory mandate, the STB adhered to the market-based regulatory policy of the Staggers Act and ICCTA and declined invitations to impose blanket “interchange,” “bottleneck,” or “access” regulation. *See Central Power & Light Co. v. Southern Pac. Transp. Co.*, 1 S.T.B. 1059 (1996), 2 S.T.B. 235 (1997), *aff’d sub nom. MidAmerican Energy Co. v. STB*, 169 F.3d 1099 (8th Cir. 1999).

The results demonstrate the wisdom of that adherence to the principles of the 4R and Staggers Acts. A freight rail industry that was almost moribund in the late 1970s slowly crept back to life. Freed to set demand-based rates, railroads reacted by pricing their services to meet the requirements of the individual markets in which they operated. They withdrew from rate bureaus and began independently pricing their portions of through movements as well as their single-line rates. Market-based prices encouraged market-based investment, and investment capital began to return to the industry. With the demise of the old “open routing” regulatory regime, railroads had greater assurance that their investments in efficient routes and facilities would be rewarded, and they were able to build greater density on their main lines and justify upgrades to key yards. As Congress concluded in passing the ICCTA, the deregulatory approach of the Staggers Act “produced a renaissance in the railroad industry.” H.R. Rep. No. 104-311, at 91.

Many Class I railroads combined, largely end-to-end, to enhance their ability to provide single-line service over major routes and consolidate facilities. At the same time, the number of

regional and shortline railroads dramatically increased as they took advantage of their lower cost structures to maintain and grow local gathering networks.³ The productivity of the industry surged, and much of that productivity was passed on to shippers in the form of lower rates. Lanigan VS at 5, 10. Today, rail rates across the country are significantly lower in real terms than they were when the Staggers Act was passed. *Id.* at 10 And the railroads are on much firmer financial footing. None of the Class I railroads has achieved long-term revenue adequacy, but they have made substantial progress toward that vital financial and statutory goal. *See Railroad Revenue Adequacy—2009 Determination*, STB Docket No. EP 552 (Sub-No. 14) (served Nov. 10, 2010).

In the face of this clear validation of the deregulatory mandate of the Staggers Act and ICCTA—and clear vindication of the ICC’s and STB’s implementation of that mandate—some of the shipper interests in this proceeding claim that they do not seek to have the Board impose more regulation on the railroads, but only to impose more “competition.” *See, e.g.*, Alliance Comments at 4-5. However, the Board’s imposition of routing or rate requirements on railroads, however denominated, is the very definition of regulation. Such regulation can be justified in situations where a railroad has demonstrably abused its market power—as the STB’s rules currently provide (*see* 49 C.F.R. Part 1144)—but the shipper interests seeking more “competitive access” do not want to restrict it to abusive situations. Even where traffic is moving efficiently, they want the STB to micro-manage the railroads’ routes and rates, harkening back to the kind of “open routing” philosophy that helped bring the industry to its knees before the modern era of

³ A study of rail competition undertaken by Christensen Associates at the STB’s request concluded that the total number of railroads in the country increased from around 490 in the mid-1980s to 559 in 2009. Laurits R. Christensen Assoc., Inc., *A Study of Competition in the U.S. Freight Railroad Industry and Analysis of Proposals That Might Enhance Competition: Revised Final Report* (2009) (“Christensen Report”), at ES-8.

rail deregulation. *See, e.g., Western Railroads—Agreement*, 364 I.C.C. at 648-49 (holding that independent, market-based rate and route decisions would promote “a sound, economic, and efficient rail system” and that “[t]he elimination of costly, circuitous and inefficient routes will benefit the industry as well as its customers.”)

Some of the commenters claim that they do not want to return to an “open routing” regime, but only to have the STB intervene when a railroad’s rates exceed certain R/VC ratios. *See, e.g., CCCS Comments* at 75-82. They do not claim that rates set at those R/VC ratios are unreasonably high, or demonstrate that the traffic is moving inefficiently, or that the shipper is otherwise receiving poor service. For all intents and purposes, therefore, they want to use access remedies to curtail differential pricing. As the Board well knows, however, demand-based differential pricing is the cornerstone of the railroads’ ability to cover their fixed and common costs. *See, e.g., Coal Rate Guidelines—Nationwide*, 1 I.C.C.2d at 526-27 (explaining that “the cost structure of the railroad industry necessitates differential pricing of rail services” and endorsing market-based pricing). If a shipper believes that it is being charged an unreasonably high rate for the through service it receives, then its remedy lies in the Board’s rate reasonableness standards. If it is receiving efficient service at a reasonable rate, however, it should not be permitted to use “access” regulation as a back-door method to undermine the railroad’s rates.

A few commenters make a frontal assault on the STB’s market dominance and rate reasonableness rules. They claim that the railroads have “duopolies” in the West and East that make access remedies of questionable utility. *See, e.g., WCTL Comments* at 23-30. Some even suggest that the STB should reopen the Class I rail mergers of the 1990s to impose unarticulated regulatory conditions. *See, e.g., Olin Comments* at 18-22. They also claim that the industry is

currently awash in excess profits that the STB should curtail. *See, e.g.*, AECC Comments at 4. While these claims are far afield from the access issues framed by the STB in this proceeding, we address these attacks on the structure and financial progress of the industry in the remainder of these reply comments and in the attached verified statement of Mr. Lanigan.

II. THE STRUCTURE OF THE RAIL INDUSTRY

Contrary to the suggestion of some shipper interests, there are considerably more railroads operating in the United States today than at the time the Staggers Act was passed. While there are fewer Class I railroads, there are many more regional and shortline railroads, and together they provide much more competitive service than was possible under the old structure. Among the regulatory reforms that Congress mandated in the Staggers Act were provisions that encouraged rail mergers, so that Class I railroads could capitalize on economies of scale and single-line service on major routes, as well as consolidate redundant facilities. Staggers Act, Section 228 (amending 49 U.S.C. §§ 11344 and 11345). At the same time, Congress made it easier for Class I railroads to spin off rail lines to regional and shortline carriers with lower costs and a local focus that helped retain and grow traffic on lower density lines. The resulting restructuring of the rail industry was one of the key drivers of the post-Staggers productivity improvements that benefited the shipping public as well as the rail industry. Lanigan VS at 4-5.

Some of the shipper commenters, however, suggest that the rail mergers of the 1990s created “duopolies” that have facilitated deleterious “parallel pricing” or “conscious parallelism” by the railroads, and they suggest that new regulatory requirements are necessary to ameliorate this allegedly anticompetitive state of affairs. *See* Olin Comments at 18-19. Arguments for the post hoc imposition of blanket merger conditions are far beyond the scope of this proceeding, and are unfounded from both a legal and practical perspective. There is no precedent for the

long reach back that the shippers seek and no way that retroactive conditions could be imposed without disrupting the settled interests and expectations of numerous parties and unraveling scores of existing commercial relationships for shippers and railroads alike.

In any event, the suggestion that shippers have suffered increased rates as a result of Class I rail mergers in the 1990s is wrong. First, the idea that those mergers increased the railroads' market power rests on a misperception about rail markets. "Captive" shippers generally do not become more captive when two railroads combine end-to-end, and most of the mergers in the 1990s were end-to-end. As the STB found in approving those mergers, the suggestion that "captive" shippers require special regulatory protections simply because two railroads have combined end-to-end to become one railroad is incorrect. *See, e.g., Burlington Northern, Et Al.—Merger—Santa Fe Pacific, Et Al.*, 10 I.C.C.2d 661, 725 (1995). In the instances where a non-captive shipper became captive as a result of a merger, the STB imposed conditions to remedy that effect; but the STB properly avoided any unnecessary additional regulation. *See, e.g., id.* at 761-62. The result, as the STB predicted, was *enhanced* competition from the merged railroads.

The 1995 merger of the Burlington Northern Railroad ("BN") and The Atchison, Topeka and Santa Fe Railway Company ("ATSF") exemplifies this phenomenon. The ability of the combined railroads to provide more efficient single-line service, to internally reroute traffic to achieve greater traffic densities, to combine their car and locomotive fleets for greater efficiencies, to reduce their overhead costs, and to avoid duplicative capital expenditures benefited both the railroads and their customers. *Lanigan VS* at 2-5. BNSF expanded the overall volume of service the two railroads had provided while dramatically improving the efficiency of its operations and its service quality. *Id.* It managed to pour billions of dollars into plant and

equipment to sustain and enhance its system while significantly improving its financial condition. *Id.* at 6.

WCTL focuses on coal traffic from the Powder River Basin (“PRB”) as indicative of the alleged deleterious effects of the Class I rail mergers of the 1990s. *See* WCTL Comments, Richards VS at 7-19. But in fact the PRB provides a good example of how the mergers of the 1990s *enhanced* rather than diminished competition. BN and the Chicago and Northwestern Transportation Company (“CNW”) were the original railroads serving the PRB. When Union Pacific Railroad (“UP”) acquired CNW, it did not diminish competition in the PRB, but in fact enhanced competition by replacing CNW with a railroad that had much greater financial resources and the largest rail network in the country. BN’s merger with ATSF further enhanced competition for PRB traffic by extending BNSF’s single-line reach and enabling it to consolidate facilities for greater efficiency. Lanigan VS at 4. Furthermore, conditions were imposed in the BN/ATSF and UP/SP mergers that ameliorated any shipper captivity that resulted from those mergers. Thus, the suggestion that competition for PRB traffic was diminished by the BN/ATSF or the UP/CNW and UP/SP mergers is simply groundless.

Yet WCTL argues that the fact the rail prices began to increase around 2004, after they had steadily declined for over two decades, shows that the railroads have “duopoly power” as a result of the mergers that should be remedied by the Board. *See* WCTL Comments, Richards VS at 16-19. This argument, which is echoed by non-PRB shipper interests as well, is without merit. *See, e.g.,* Alliance Comments at 15-16. When rates generally increase across all traffic categories, the explanation lies not in unsubstantiated conspiracy theories but in the simple fact, as the STB’s own Christensen study found, that costs began to increase in 2004, which alone can account for much of the rates increases to date. Christensen Report, at ES-5, ES-16; *see also*

Laurits R. Christensen Assoc., Inc, *An Update to the Study of Competition in the U.S. Freight Railroad Industry: Final Report* (2010) (“*Christensen Update*”), at i (railroads’ “marginal cost has been increasing at a faster average annual rate than railroad revenue per ton-mile”). At the same time, after years of enormous productivity growth, the industry’s ability to wring more cost savings from consolidation and technology began to slow, and the railroads began to pour even more money into maintaining and enhancing their capacity to meet the demand for their services. Lanigan VS at 9-11.

Moreover, demand for rail service surged across most traffic categories as the nation’s economy expanded in the mid-2000s and railroads priced their services accordingly. *Id.* The increase in their profitability finally began to put the railroads on the kind of sound financial footing that Congress envisioned in the Staggers Act, but the railroads still did not earn, and have not earned, sustained revenues sufficient in the long run to replace the assets required to meet shipper demand. Rates in real terms still remain below their level when the Staggers Act was passed. *Id.* at 10. In short, shipper complaints about abuse of market power arising from rate increases in the 2000s are not supported by the facts. -

WCTL opines that rate increases on PRB coal traffic are attributable to BNSF’s and UP’s issuance of published tariffs applicable to that traffic in 2003 and 2004. WCTL Comments, Richards VS at 13-15. There are several reasons why this argument is wrong. As described above, increases in rates on PRB coal traffic coincided with increases in rates on all traffic nationwide in the same time period as a result of increased costs and market demand. BNSF certainly does not agree that the issuance of published tariffs is suspect. A great deal of traffic in the rail industry moves under published tariffs—tariffs covering the movement of agricultural products are a good example—and many shippers prefer them. But the question is moot with

respect to PRB coal movements, because those published tariffs have not supplanted confidential contracts, which have been and continue to be the dominant mode of pricing those movements. Lanigan VS at 12. Not only does WCTL concede this, but WCTL also complains about the confidentiality of those contracts. WCTL Comments, Richards VS at 15, 18. Finally, as Mr. Lanigan states in his verified statement, assertions that BNSF and UP do not compete for the business of coal shippers, or non-coal shippers, are without any factual basis. BNSF competes hard with UP for shippers' business, and both loses and gains traffic, including coal traffic, in the process. *Id.* at 12-13.

The bottom line is that the restructuring of the rail industry after passage of the Staggers Act, including the mergers of the 1990s, enhanced competition in the rail industry. Rates went down while service improved and reinvestment in the industry grew. The fact that rates went up as demand and costs increased in the 2000s, after decades of rate reductions, reflects exactly the kind of price adjustment that occurs in every competitive industry where demand and costs fluctuate. And the fact that railroads' financial situation continued to improve reflects exactly the progress toward revenue adequacy that Congress, the ICC, and the STB intended.

III. THE FINANCIAL CONDITION OF THE RAIL INDUSTRY

Many of the shipper interests commenting in this proceeding assert that the railroad industry is highly profitable and, accordingly, railroads can afford to have revenues siphoned off to some shippers by various forms of new access regulation. *See, e.g.,* Alliance Comments at 16. Of course, these shippers do not demonstrate that their proposals for new access regulation are necessary to address abuses of market power at particular locations. Instead, they suggest that the STB need not concern itself with the railroads' loss of revenue under new access regulation,

because a number of different indicators of railroad profitability show that the industry is earning supra-competitive returns. *See, e.g.,* WCTL Comments at 31-35.

With respect to BNSF, several shipper commenters point to an observation by Warren Buffett that its investment in BNSF had yielded good returns. *See, e.g.,* Alliance Comments at 19-20. But none of these commenters show that any railroad, including BNSF, has reached a sustained level of earnings that will permit it to replace its productive assets in the long term. All of the measures of profitability and financial health cited by these commenters are measure of *short-term* financial strength. Whether BNSF or any other railroad has attained a level of earnings sufficient to meet demand and replace its system in the long run depends on a *long-term* measure of revenue adequacy. BNSF will be required to make many billions of dollars in capital investment in the future to have the capacity to meet shipper demand. Lanigan VS at 6, 13. Whether that investment will make economic sense for BNSF depends on whether, over the long term, the potential return outweighs the risks—including the risk from changes in regulatory policy. *Id.* at 13-14.

None of the shipper commenters attempts an economic demonstration that the various financial ratios they propose are suitable measures of long-term revenue adequacy in the rail industry. The STB need only refer to the ICC's own extensive deliberations on the subject to refute the idea that the kinds of financial ratios proposed by these commenters are good indicators of revenue adequacy. Prior to passage of the Staggers Act, the ICC experimented with a variety of different indicators of financial health—including return on shareholders' equity, fixed charge coverage ratios, proportion of debt in the capital structure, ratio of market value of common stock to book value, "funds flow" analyses, operating ratios, and throw-off-to-debt ratios. *See, e.g., Standards and Procedures for the Establishment of Adequate Railroad Revenue*

Levels (Ex Parte No. 338), 358 I.C.C. 844 (1978); *Adequacy of Railroad Revenue—1978*

Determination (Ex Parte No. 352), 362 I.C.C. 199 (1979). The ICC found, among other things, that even the Pittsburgh and Lake Erie Railroad, which subsequently filed for bankruptcy, could be deemed revenue adequate because it had a low operating ratio, a low debt ratio, and a sizable investment program. 362 I.C.C. at 327-28.

After the Staggers Act was passed, the ICC revisited its standards for revenue adequacy and determined that the financial ratios and “funds flow” approaches it had briefly sanctioned “were and are appropriate as indicators only of the short-term viability of railroads.” *Standards for Railroad Revenue Adequacy (Ex Parte No. 393)*, 364 I.C.C. 803, 808 (1981). The ICC explained further:

If we adopted the Ex Parte No. 353 minimum or short-term standard for use here, we would likely in the next few years find ourselves denying a railroad the pricing flexibility necessary to obtain long-term revenue adequacy simply because that railroad was making some progress toward achieving that goal. In short, we would be assigning the railroads the Sisyphean task of working toward revenue adequacy, and every time it came close robbing it of the very means it had used to get there. We do not believe this is desirable nor do we believe it was intended by Congress. [*Id.*]

Accordingly, the STB adopted a rate of return on investment equal to the current cost of capital as the standard of revenue adequacy. As the ICC observed, “[s]uch a standard is widely agreed to be the minimum necessary to attract and maintain capital in the railroad, or any other, industry.” *Id.* at 809. Furthermore, it is the only standard that meets the statutory definition of revenue adequacy at 49 U.S.C. § 10704(a)(2):

The Board shall maintain and revise as necessary standards and procedures for establishing revenue levels for rail carriers providing transportation subject to its jurisdiction under this part that are adequate, under honest, economical, and efficient management, to cover total operating expenses, including depreciation and obsolescence, *plus a reasonable and economic*

profit or return (or both) on capital employed in the business.
[Emphasis added]

As noted earlier, the railroad industry was in poor financial condition when the Staggers Act was passed, and it has taken three decades for the industry to progress financially to the point where there is a realistic prospect of achieving revenue adequacy. The industry demonstrably has not reached that goal, even when measured by a single year, much less the Board's long-term standards. *See Railroad Revenue Adequacy—2009 Determination*, STB Docket No. EP 552 (Sub-No. 14) (served Nov. 10, 2010).

Finally, one shipper commenter, NRG Energy, Inc., claims that the STB should not only revise its methodology for calculating revenue adequacy but also change its use of generally accepted accounting principles ("GAAP") to value a railroad's assets after a merger or acquisition. NRG claims that where the purchase price of the assets exceeds their book value, including the "acquisition premium" in the railroad's rate base "distorts the true financial health of the railroad," and points to Berkshire's acquisition of BNSF as an example. NRG Comments at 2. Not only is this "acquisition premium" claim well outside the scope of this proceeding about competitive access, but it has been thoroughly litigated and repeatedly rejected by this agency and the courts.⁴ NRG complains that the use of acquisition cost could "skew" the STB's revenue adequacy and variable cost calculations, but the STB has specifically addressed both issues and concluded the opposite. *See, e.g., Conrail*, 3 S.T.B. at 262-65. The STB stressed there that acquisition cost "represents by far the best evidence of the current market value of

⁴ *See Major Railroad Consolidation Procedures*, STB Ex Parte No. 582 (Sub-No. 1), slip op. at 28, 2001 WL 648944, *18 (served June 11, 2001); *CSX Corp.—Control—Conrail, Inc.*, 3 S.T.B. 196, 262-65 (1998) ("*Conrail*"), *aff'd sub nom. Assoc. of Amer. RR's v. ICC*, 978 F.2d 737, 741-43 (D.C. Cir. 1992); *Railroad Revenue Adequacy—1988 Determination*, 6 I.C.C.2d 933, 935-42 (1990), *aff'd sub nom. Erie-Niagara Rail Steering Comm. v. STB*, 247 F.3d 437, 442-43 (2d Cir. 2001).

[railroad] properties.” *Id.* at 265. Virtually every Class I railroad merger or acquisition that has taken place in the past two decades has involved an “acquisition premium,” and in every instance the acquisition cost has been booked by the ICC and the STB using GAAP accounting. NRG has offered no reason why Berkshire’s acquisition of BNSF should be an exception.

CONCLUSION

The Board should not permit this proceeding about access issues to be used to mount a collateral attack on the economic model underpinning our freight railroad industry. As discussed in BNSF’s initial comments, there is ample regulation in place to protect shippers against unreasonable rates, poor service, or other abuses. None of the commenters proposing alternative access standards has demonstrated why legitimate shipper concerns cannot be met under the Board’s existing regulatory rate or service frameworks. The kind of intrusive access regulation being promoted by a subset of shippers may give them short-term benefits, but it is not only the railroads that will suffer. The shipping community as a whole will also pay for the diminution in investment and operational inefficiency that would result. It has taken BNSF and its predecessors over three decades since the passage of the Staggers Act to optimize the combined railroad network, and altering the Board’s access policies to move back toward an open routing regime would significantly jeopardize the efficiency of the network’s operations. The deregulatory approach taken by Congress in the Staggers Act and ICCTA, and implemented by

the ICC and the STB, has been a demonstrable success and the Board should refrain from instituting radical new access regulation that jeopardizes these hard-won successes.

Roger P. Nober
Richard E. Weicher
Jill K. Mulligan
BNSF RAILWAY COMPANY
2500 Lou Menk Drive
Fort Worth, TX 76131

Respectfully submitted,



Robert M. Jenkins III
MAYER BROWN LLP
1999 K Street, NW
Washington, DC 20006

Counsel for BNSF Railway Company

Dated: May 27, 2011

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

EX PARTE NO. 705

COMPETITION IN THE RAILROAD INDUSTRY

**VERIFIED STATEMENT OF
JOHN P. LANIGAN**

My name is John P. Lanigan. I am Executive Vice President and Chief Marketing Officer for BNSF Railway Company. I have been in this position since 2003 and have responsibility for BNSF's sales, marketing, customer service, and economic development. I lead the activities of the four business groups within our Marketing Department: Agricultural Products, Coal, Consumer Products, and Industrial Products. Prior to joining BNSF, I spent over sixteen years with Schneider National, Inc., one of the largest truckload motor carriers in the United States.

I understand that the STB in this proceeding has sought comments regarding the possibility of altering its longstanding "access" doctrines. In addition to commenting on the existing access doctrines, several shipper interests have submitted comments in this proceeding claiming that new regulation is justified because, they assert, the intensity of competition among railroads, in particular western railroads, has diminished in recent years, largely as a result of Class I railroad mergers in the 1990s, including the merger of Burlington Northern Railroad ("BN") and The Atchison, Topeka and Santa Fe Railway ("ATSF") in 1995. I am submitting this statement to respond to those filings.

As I explain below, BNSF competes for traffic in every commodity group. We compete hard for business at BNSF, as we did at Schneider. At Schneider, we competed not only with other trucking companies, but with railroads as well. At BNSF, we compete with other railroads, trucking companies, and barge companies on a daily basis. Our goal is to provide our customers with competitive, high-value service that will cause them to choose BNSF over our rail competitors or other modes of freight transportation. Our corporate vision is to realize the tremendous potential of BNSF by providing transportation services that consistently meet our customers' expectations, and that vision extends to every customer, every day, in every customer circumstance.

The BN/ATSF merger contributed substantially to BNSF's competitive capacity and significantly improved BNSF's ability to compete in the marketplace for transportation services. Shippers have benefitted from the enhanced service BNSF has been able to provide, as well as the enormous investment BNSF has made improving our system. BNSF's continued ability and readiness to reinvest in our system and further expand our service offerings depends on the continued opportunity to earn a reasonable return.

In their filings, some shippers or shipper trade associations assert that the BN/ATSF merger led to a reduction in competition. Distilling all of the arguments to their core, these commenters point to recent rate increases for rail service as evidence. I strongly disagree with these assertions. Rate increases over the past eight years are not evidence of a reduction in competition among railroads flowing from the rail mergers of the 1990s. Coming out of the manufacturing-led recession of the early 2000s, consumer demand and housing starts soared to all-time record levels. This demand led to rapid growth in rail loadings, culminating in record rail demand in 2006. I know from extensive experience in the transportation industry that prices

often increase even where there is vigorous competition, particularly when demand exceeds capacity and costs increase. BNSF's rate increases in recent years resulted directly from cost increases and increases in demand for service on increasingly constrained rail capacity coupled with rising costs, not from the BN/ATSF merger or any subsequent reduction in the intensity with which BNSF competes for business.

There can be no dispute that BNSF's costs have increased, particularly for our two largest expense categories, fuel and wages. For example, in 1996, the total cost of diesel fuel for BNSF was \$727 million. In 2010, our cost of fuel had increased to \$3,016 million. We have also seen increases in our personnel costs over that time. Similarly, there can be no dispute that volumes have increased on BNSF. In 1996 the railroad hauled 6,992 thousand units of freight; by 2006 that number had increased to 10,637 thousand, and even after the recent recession the number of units hauled in 2010 stood at 9,157 thousand units. Finally, since 1996 BNSF made \$39 billion in capital investments in our network. All of these are costs and expenses that must be reflected in our rates.

I interact every day with our customers, and they are frank and open about their expectations of the railroad in terms of service and rate levels, and I believe that the negative filings before the STB in this proceeding represent a vocal but small minority of the almost ten thousand companies with which we do business. Rail rates are determined by market forces as the Staggers Act envisioned. The critical shippers appear to be complaining about the level of their rates. But the STB's existing rate reasonableness regime already provides shippers with several options for seeking appropriate rate relief. BNSF also has mechanisms outside the STB's procedures, like the Montana Alternative Dispute Resolution program for rate level challenges by Montana grain shippers as a supplement to the rate reasonableness challenge rights shippers

enjoy before the Board. The STB should refrain from imposing unnecessary new regulations that micro-manage railroads' operations, artificially depress rates, and jeopardize BNSF's ability to invest in our network to meet current and future transportation demand.

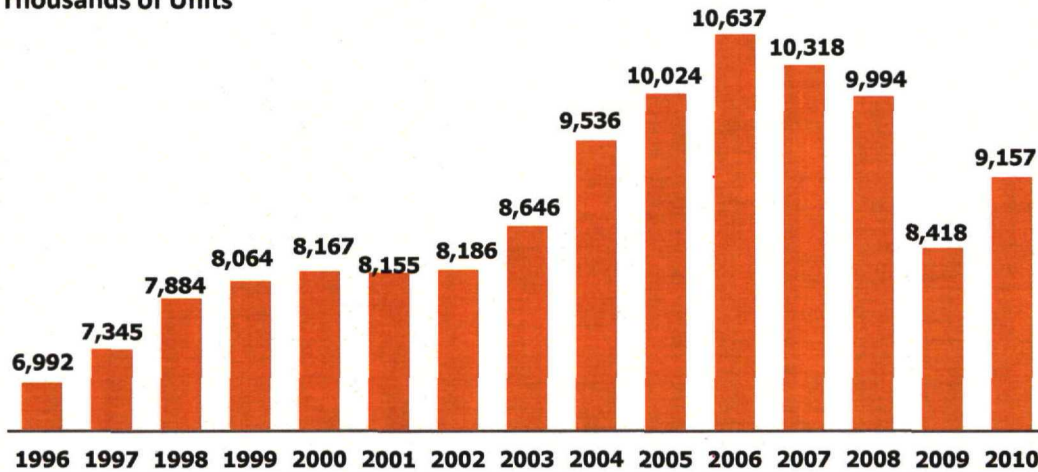
1. The Competitive Benefits of the BN/ATSF Merger.

I was not at BNSF at the time of the BN/ATSF merger, but I can personally attest to the competitive benefits that resulted from the marketing reach, diversity of traffic, and operating efficiencies produced by the merger. The BN/ATSF merger integrated two rail networks with little overlap. It created an expanded rail system that could provide new single-line service from points on BN's system to points on ATSF's system. It significantly diversified the traffic bases of the two railroads, balancing BN's strength in coal and grain with ATSF's strength in intermodal traffic. Among other things, it enabled the two railroads to internally reroute traffic to achieve greater traffic densities, to integrate the productive facilities of the railroads, to combine car and locomotive fleets for greater efficiency, to reduce overhead costs, and to target capital expenditures to projects yielding the greatest benefits to the combined system and our customers.

The result was exactly as the two railroads predicted. The merger created a stronger railroad with the size and scale to compete more effectively for domestic and international business, including our intermodal business, and to move significant volumes of traffic off the highways and on to rail. Over time, the new BNSF system significantly expanded both the volume of rail services it provided and the efficiency of those services. Between 1996 and 2006, BNSF's total volume of traffic increased over 50%. The recession beginning in 2007 took a heavy toll on BNSF's business, but in 2010 our volume was still over 30% higher than in 1996.

BNSF Traffic Volume

Thousands of Units



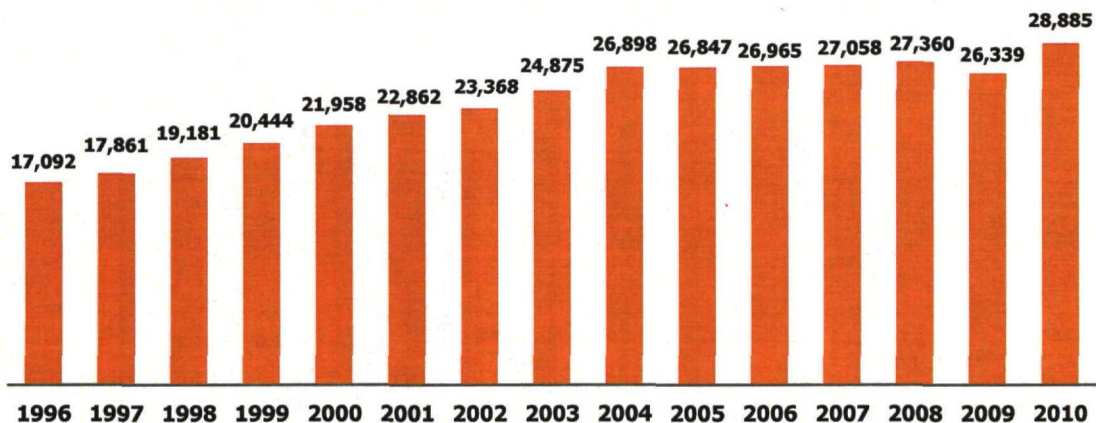
BNSF's traffic increased in every major product group between 1996 and 2006.

We grew our consumer products traffic by 76%, our agricultural products traffic by 66%, our coal traffic by 33%, and our industrial products traffic by 19%. Even with the effects of the recession, in 2010 our volume in every commodity group except industrial products was substantially higher than in 1996.

The efficiency of BNSF's operations also improved dramatically.

BNSF Efficiency of Operations

Thousand GTMs per Employee

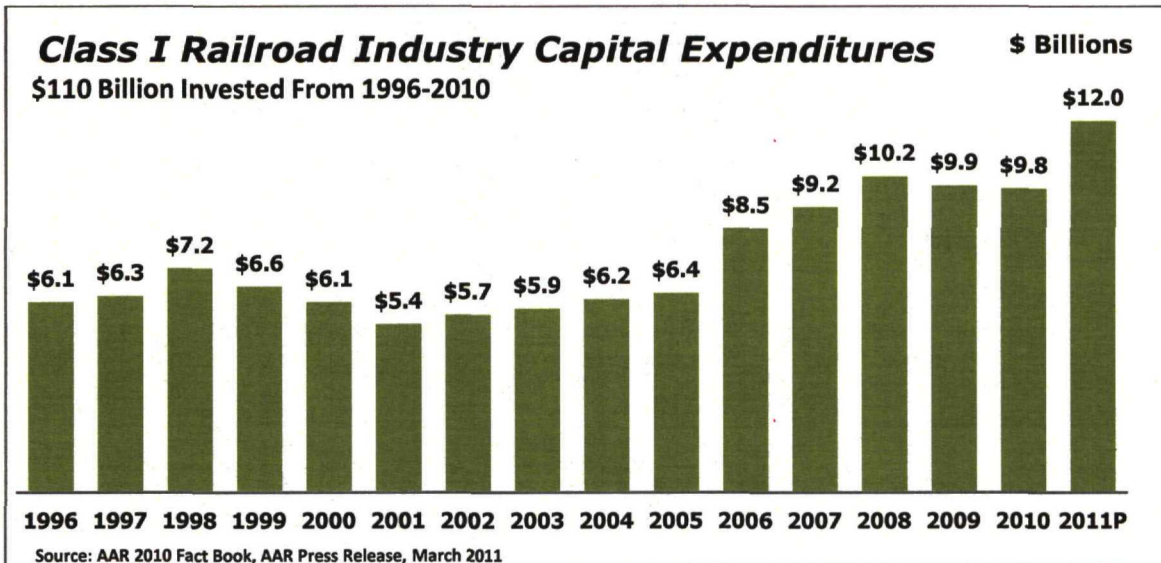


Not only was our employee productivity higher, but our locomotive utilization was much better and we carried more tonnage per gallon of fuel.

All of these improvements required billions of dollars in capital investment. Between 1996 and 2010, BNSF poured over \$39 billion into the network to both maintain and expand our plant, equipment and technology. We estimate that in 2011 we will spend another \$3.5 billion to sustain and enhance our capacity.



BNSF was not alone. The other railroads also invested billions of dollars into improving their rail systems and aggressively competed for business.



These benefits would be at risk if the STB were to adopt new regulation that would artificially reduce rates for a minority of shippers while substantially increasing the operational complexities and costs of providing service to *all* shippers. Many of the proposals advanced by commenting shippers in their opening submissions seem to be aimed at returning the railroads to a Pre-Staggers Act open interchange regime. Such an approach would significantly disrupt the substantial progress we have made over the last two decades by interfering with the cost efficiency of our current network, compromising network velocity, and making it harder for BNSF to meaningfully compete for business.

2. The Claims of “Parallel Pricing” and Excess Profits

Despite the fact that the BN/ATSF merger delivered exactly what was predicted, some of the shipper interests in this proceeding claim that the Class I mergers of the 1990s, including the BN/ATSF merger, have somehow led to a reduction in competition among railroads. As evidence, they point to alleged “parallel pricing” by BNSF and other Class I railroads, to so called “conscious parallelism” between BNSF and the other large Western railroad, Union Pacific (“UP”), and to excess profits by the four largest railroads. As remedies, they suggest that

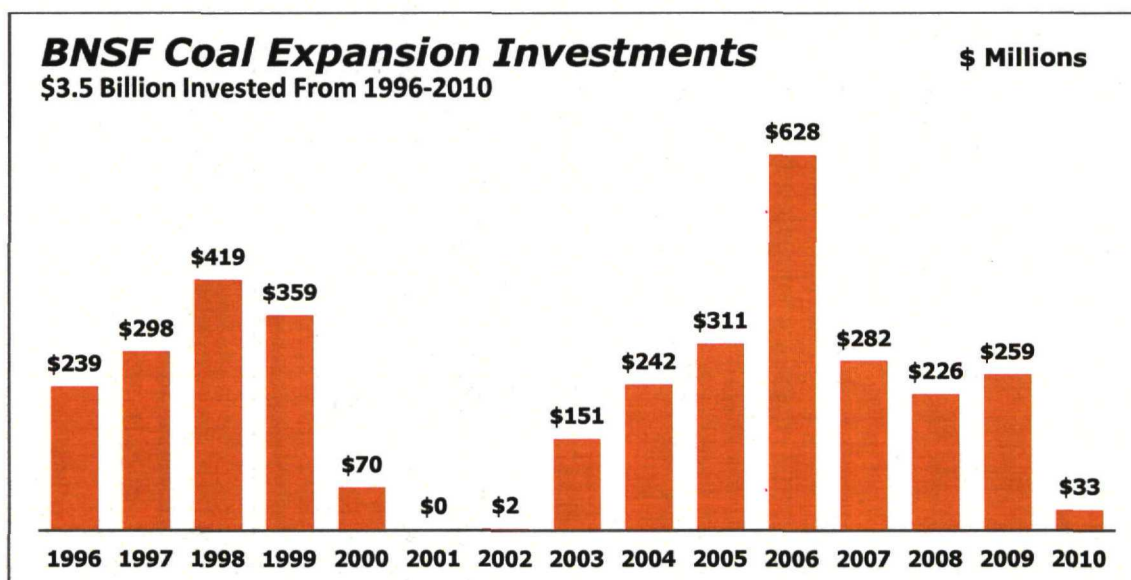
the mergers of the 1990s should be reopened to impose new access conditions, or that the STB should otherwise impose new access or rate reasonableness regulations. The justifications used by these commenting shippers for more regulation are wrong on several levels.

In the first place, they rest on mistaken assumptions about the markets for rail transportation. When two railroads combine end-to-end, that does not diminish the number of railroads serving the origin or the number of railroads serving the destination. And, of course, it does not diminish the competition from other transportation modes, like trucks and barges. The claim of some shippers that competition was reduced as a result of certain end-to-end mergers ignores the vast diversity of market conditions and competitive options in different transportation markets. Those shippers also ignore the benefits produced by those mergers that have allowed railroads to compete more effectively for business. As I discussed above, railroads combining end-to-end, like BN and ATSF, do have the opportunity to create more efficient networks, and compete more effectively for long-haul service. And that is exactly what transpired as a result of the BN/ATSF merger. BNSF was able to improve its service and grow the combined railroads' business in every major traffic category.

Some of the coal shipper interests make much of the so-called "duopoly" that BNSF and UP have for coal service to and from the Powder River Basin ("PRB"), but the suggestion that the rail mergers of the 1990s created a PRB "duopoly" or in any way diminished competition could not be more wrong. The PRB has never been served by more than two railroads—first, BN and the Chicago and North Western Transportation Company ("CNW"), and then BNSF and UP (as a result of the BN/ATSF merger and the UP/CNW merger). There is no question that UP's acquisition of the financially troubled CNW actually enhanced competition in the PRB. BNSF and UP were able to offer more single-line service to and from the PRB and they had

greater financial resources to invest in coal service. The resulting service improvements have made PRB coal more competitive in eastern U.S. markets and in export markets, which can be served by both BNSF and UP.

Indeed, since the mergers, BNSF has invested enormous amounts into the Joint Line that serves the PRB, as well as other facilities and equipment dedicated to coal service. In 1985, the Joint Line handled 19 million tons of coal. Volume grew steadily and by 2005 the Joint Line capacity had grown to handle a record 325 million tons. BNSF and UP agreed to add a third and fourth mainline, which enabled the Joint Line to handle in excess of 400 million tons. Of course, BNSF's investment in coal service covered more than the Joint Line. As the chart below shows, BNSF invested over \$3.5 billion between 1996 and 2010 to expand its capacity to handle increased coal traffic. This does not include the substantial on-going investment required to maintain and replace our existing coal infrastructure.

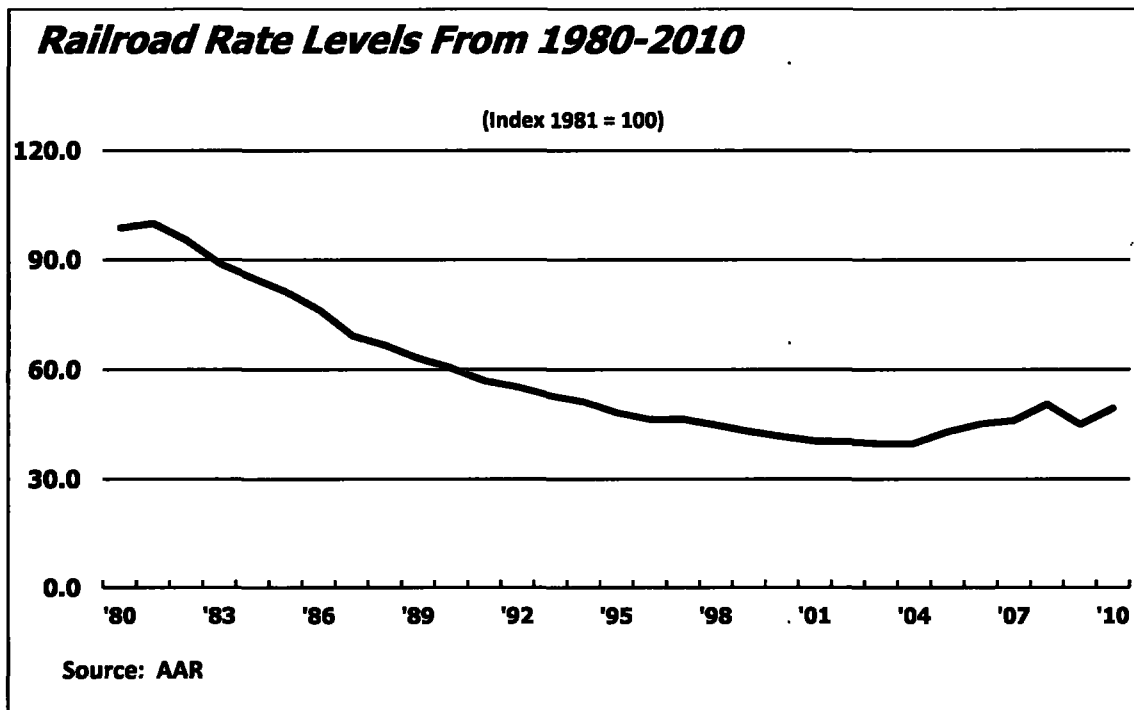


BNSF's investment in its competitive capacity has by no means been limited to coal. BNSF has also made substantial capital investments in infrastructure across our network that

benefits many other types of traffic. Growth in one area contributes to growth in another by expanding the base of traffic that shares the common costs of the network.

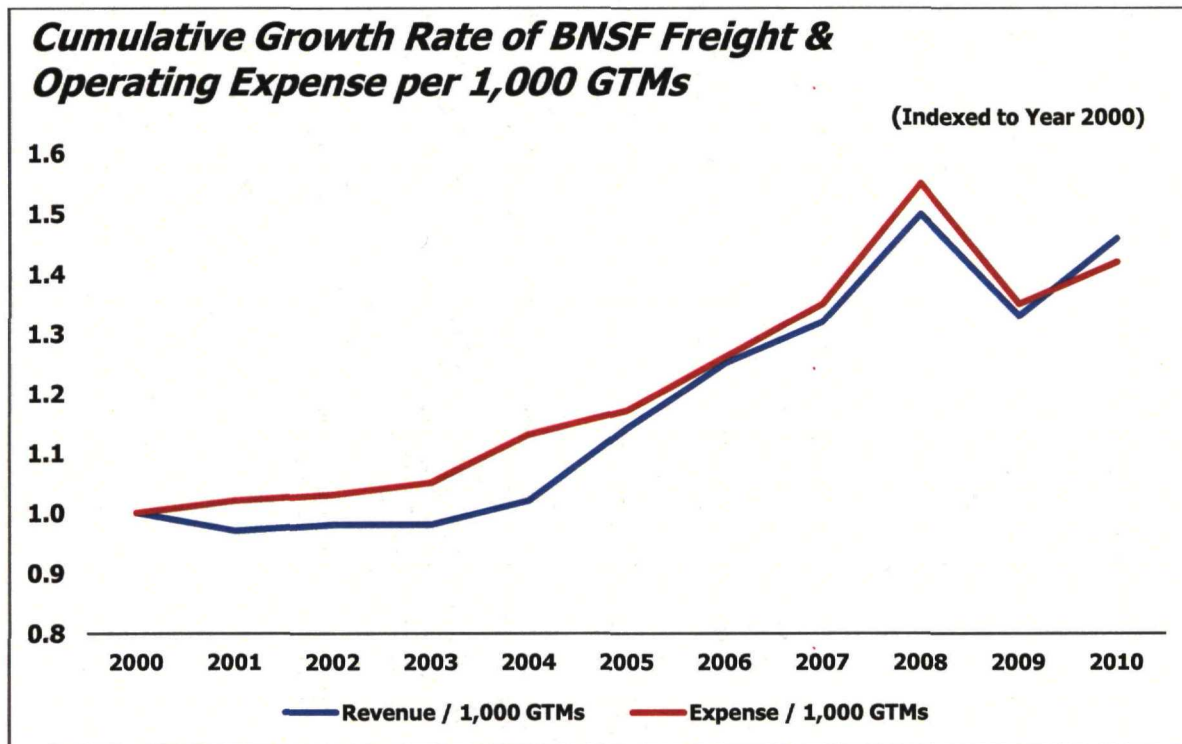
In short, shippers cannot make any serious claim that competition was reduced by the structural changes in the rail network that resulted from the combination of BN and ATSF. Those changes have been uniformly positive. Some shipper interests, however, argue that pricing competition must have been reduced, because, after over two decades of steady decline, BNSF's and other railroads' prices began to rise around 2004.

One major problem with this argument as it applies to western railroads is that the BN/ATSF and the UP/SP mergers took place in the mid-1990s, but the increases in prices did not take place until many years later. As the chart below demonstrates, rail prices in fact continued to trend downward in real terms after the mergers.



The rate increases in the mid-2000s were attributable to market forces. An enormous increase in demand from the shipping public for rail service coincided with a substantial increase

in costs, at the same time that the productivity gains that had characterized the industry since the passage of the Staggers Act began to slow. BNSF, like other railroads, was stretched to meet that demand and cover its costs, and we set prices accordingly. For many years, the increase in our revenues did not keep pace with the increase in our costs.



My experience in the trucking industry involved similar dynamics—when costs and demand went up, particularly in a capacity constrained environment, rates increased; when demand no longer exceeded capacity and costs fell, so did rates. Anyone familiar with transportation markets knows that prices can rise even where there is competition among the providers of service. When costs increase and demand increases, rates will inevitably rise. These were the factors that led to rate increases in recent years, not any reduction in competition.

In addition, BNSF saw in this period the expiration of a large number of long-term contracts that contained below-market rates. While some shippers faced significantly higher rates than they had enjoyed under their old contracts, those higher rates were in line with market

based rates that BNSF negotiated with similarly situated shippers. BNSF also poured even more investment into plant, equipment and technology in an effort to provide the best service it could to as many shippers as possible. BNSF's price increases were a direct response to demand, capacity and cost conditions in the mid-2000s, not to any structural after effects of the rail mergers in the mid-1990s or any diminution of competition.

A couple of coal interests assert that BNSF's and UP's prices increased for PRB coal movements because in 2003 and 2004 BNSF and UP introduced published coal tariffs. As the STB well knows, published tariffs are common in the rail industry, and many of our shippers prefer them. Agricultural products, for example, move almost entirely under tariff rates. Moreover, increased BNSF rates for PRB coal transportation were entirely consistent with the increases in rates across all commodity groups, and, as described above, were driven by increased demand and constrained capacity. In any event, UP's coal tariff rates were never made public and BNSF's were public only for a limited period of time. Additionally, the coal shipper interests acknowledge that the vast majority of PRB coal continues to move under private, confidential contracts as it has since the inception of vigorous rail competition for PRB movements in the early 1980s.

Some shipper commenters, including some coal shipper interests, assert that they cannot always get the type of bids that they want for their business. Obviously, neither BNSF nor any other freight transportation company in any mode can meet every shipper's desired price or service. Demand and costs differ greatly among different types of traffic and among different shippers. But any suggestion that we do not compete for business everywhere we can is simply wrong. Other railroads, trucks, and barges also compete with us, and we cannot always retain the business we have. With respect to UP, every year since I have been at BNSF we have

competed with UP for new and existing business. We win some and we lose some. In some instances, our business losses are quite public, such as when intermodal industry leader Hub Group shifted the majority of its business away from BNSF, representing a major loss in revenue and volume to UP. Many other examples of business losses and gains are less public, though they are equally impactful. The assertions of some coal shippers that BNSF does not compete for their business and that after 2004 no coal business has shifted between BNSF and UP are categorically false.

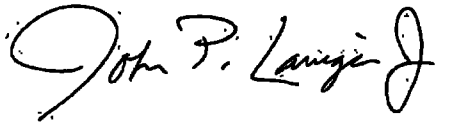
Finally, some shippers assert that Class I railroads, including BNSF, should be subjected to more regulation because we are awash in excess revenues. Several point to a statement made by Berkshire Hathaway's Chairman, Warren Buffett, that Berkshire Hathaway's acquisition of BNSF has been profitable. But asserting that this means that BNSF has reached revenue adequacy confuses the short-term profitability of Berkshire Hathaway's investment with the long-term ability of BNSF to sustain and replace its system. There is no doubt that BNSF's financial condition has improved significantly, as has the financial condition of the other Class I railroads in the United States since the passage of the Staggers Act. But there is equally no doubt that BNSF has not yet achieved the sustained level of earnings necessary to cover its long-term costs.

Railroad assets are very long-lived. BNSF, like every other railroad, must make decisions about whether to invest in new assets or replace old assets on the basis of its expectations about whether it will have a reasonable opportunity to cover the costs of that investment in the long run. BNSF is committed to maintaining and expanding our network to enable us to better serve our existing customers and to compete for new customers, but we must be able to earn a return over the long term that justifies those investments. For decades, our

customers implored us to invest to improve capacity and efficiency. It takes a profitable return to make these record investments that benefit our customers. The United States needs a strong and growing freight rail industry to compete in an increasingly global economy. Our national freight rail network, of which BNSF is the largest in terms of units and revenues, is a critical competitive advantage for our economy. Now that BNSF and other railroads, after 30 years, have finally begun to approach the level of earnings that might sustain and grow their operations in the long run, the STB should not lightly entertain proposals in this proceeding to impose new merger conditions or other regulations that jeopardize the ability and incentive of railroads to make future investments in the rail freight system.

VERIFICATION

I, John P. Lanigan, Jr., declare under penalty of perjury that the foregoing statement is true and correct and that I am qualified and authorized to file this statement.

A handwritten signature in black ink, reading "John P. Lanigan, Jr." with a stylized flourish at the end.

Executed: May 26, 2011

John P. Lanigan, Jr.